



William C. Siegel, J.D.

## Common Timberland Tax Questions and Answers

***I receive numerous letters and telephone calls from non-industrial forest landowners throughout the country who have timber tax questions. Many of the questions I've been asked during the last year should also be of interest to the readers of National Woodlands. I've therefore selected some of them, and my answers, for this issue's "Timber and Taxes."***

*I purchased 120 acres of mixed hardwoods several years ago. This past spring, as part of the process of preparing a management plan for my property, my consulting forester cruised the timber. I was told by my neighbor that I couldn't deduct the cost of the cruise from my taxes, but had to add this expense to my depletion account for the timber under IRS rules. Is this correct?*

Your timber cruise was made for management purposes in the course of managing your woodland. Its cost, therefore, is what is called an ordinary and necessary management expense. As such, it is fully deductible on your income tax return for the year the expenditure was made. The cost of a cruise made in conjunction with a timberland purchase, however—if paid for by the buyer—does have to be capitalized into the timber depletion account rather than deducted currently. And finally, the cost of a cruise made in the process of selling timber, if paid for by the seller, must be recovered by being deducted from the sale proceeds as a cost of sale.

*I own and manage forestland that has been in our family for many years. Land adjacent to mine was purchased last year by a new owner. Shortly afterwards we became involved in a dispute over the exact location of the boundary line between our two properties. A number of acres was involved. I incurred several thousand dollars in surveying and legal expenses to establish the fact that the line we had always used was in actuality the true boundary line. Can I*

*deduct the survey and other costs on my tax return?*

Although the logical answer would seem to be yes, the position of the IRS—upheld in several court decisions—is that you cannot. Costs such as you incurred to protect and defend title to a part of your woodland are deemed to be capital costs, not currently deductible expenditures. Furthermore, they must be capitalized into the basis of the land, not the basis of the timber. This means that they can never be recovered (deducted) unless you sell the land. At that time these particular costs could be deducted against the sale proceeds.

*My forest property is in another state and I don't have the opportunity to visit it very often. Last year some of my trees were stolen, but I didn't discover the theft until this year. We have not been able to identify the thief. I hired a consulting forester to help me determine the extent of my loss so I could deduct the loss on my tax return. I have two questions. The first is: On which tax return do I deduct the theft loss, last year's or this year's? My second question is: can I add the fee charged by the forester to my theft loss when I deduct it?*

Even though your timber was stolen last year, you didn't discover the loss until this year. Therefore, it must be deducted on this year's tax return. Additionally, your deduction is limited to your basis in the stolen trees. The fee you paid to determine the extent of your loss is not a part of the theft loss per se and thus cannot be added to your theft deduction. It can, however, be deducted elsewhere on your tax return as a management expense.

*Late last year I decided to harvest some of my timber. Instead of selling it "on the stump" as I always did before, I cut the trees myself. I skidded them to the roadside and hired someone to take them to the mill for me. I didn't receive my pay-*

*ment from the mill until this year. I know that I can take capital gains treatment for my cutting just as I did previously with stumpage sales. However, the person who does my taxes (not a CPA) is not certain how to do this. Can you help me?*

Assuming you had owned the trees you cut for more than one year prior to severance, you are eligible for capital gains treatment for the difference between your basis in the trees and their fair market value as stumpage on January 1 of last year. This "gain" must be reported on last year's tax return, and the capital gain tax paid on it, even though you didn't receive payment for the logs until this year. In addition, in order to be eligible for capital gains treatment, you must make what is called a Section 631(a) election on last year's tax return. This is done by checking the Section 631(a) election box on line 44 of Schedule F of Form T and providing the other information required concerning your logging operation. Form T should be attached to your tax return. The difference between the fair market value of the standing timber on January 1 of last year and the amount you received at the mill, minus the cost you incurred for delivery to the mill, is ordinary income. You should report it as such on this year's tax return.

*I spent \$2,500 in 1998 for reforestation of some of my property and preparing the site before planting. The local extension agent told me that I could deduct these costs over eight years and also take a tax credit. Because I have never treated my woodland as a business, and do not file business tax forms for it, I wrote the deduction for 1998 on the bottom of the first page of my Form 1040, following the instructions in an extension publication. I recently received a letter from the IRS telling me that I cannot take the deduction in this manner, but have to use either Schedule C or Schedule F, which are business schedules. I don't want to file as a business. Who is correct—the IRS*

or the extension publication?

The extension publication's instructions are correct. I have had a number of forest landowners over the years tell me a story similar to yours about their experiences with the IRS on this point. The reforestation amortization deductions can be taken by either businesses or investors. The deduction is what is called an "above the line" deduction, or a deduction from gross income to arrive at adjusted gross income. It is not an itemized deduction. Therefore, since you consider yourself as an investor and not

a business with respect to your forest property, the deduction is taken by writing it in at the bottom of the first page of the Form 1040 as an adjustment to gross income—exactly as you did it. The IRS has issued an administrative directive explaining that this is the correct procedure for taxpayers such as yourself. Unfortunately, not all IRS auditors are aware of its existence. I suggest you write back to the IRS and cite Section 162(a)(11) of the Internal Revenue Code.

*I recently harvested timber from my land for the third time since I've owned it. The*

*previous sales were in 1985 and 1990. When I reported the two earlier sales on my tax return, I wasn't aware that I could take a depletion deduction for part of my basis in the timber and I didn't do it. I know now that I can do this and intend to do so for this sale. My question is: since I didn't deduct any basis for the two previous sales, can I add those basis deductions to the one for this sale when I do my taxes for this year?*

Unfortunately, the answer is no. If a basis (depletion) deduction is not taken at the time that trees are harvested, the deduction is lost unless it is taken on an amended return within three years. The depletion account (basis) of your timber must be reduced by the amount of the depletion not taken—just as if it had been taken. Therefore the two deductions you failed to take are permanently lost and your basis should be reduced accordingly before you calculate the depletion deduction for the most recent sale.

*I reforested 35 acres in early 1997 after a clear-cut. In both 1998 and 1999 I spent money for chemical control of weeds and brush growing with the seedlings. Can I deduct these costs outright on my tax returns for 1998 and 1999, or do I have to treat them as capital costs and put them in my depletion account?*

The costs of competition control in young plantations are either currently deductible stand maintenance costs or capital expenditures, depending on the circumstances. If the control is absolutely necessary to insure seedling survival in sufficient numbers for adequate stocking, the expense is a capital one and must be added to the plantation capital account. It is then eligible for the reforestation amortization and credit. On the other hand, if the control merely enhances growth and vigor, and the seedlings would have survived in adequate numbers without it, the cost is a stand maintenance expenditure and currently deductible as such. Each control operation, therefore, needs to be examined separately to make the determination.

*Last year I planted hardwood seedlings on some pasture land that had not had trees on it for many years. I no longer raise cows. I've read about the tax law provision that allows planting costs to be deducted over eight years and in addition allows a ten percent tax credit. My reference refers to these provisions as the reforestation amortization and credit, implying that only reforestation following a timber harvest is eligible. Are the costs*

## "Positive" Postings

by David Rock

One Maine tree farmer along a well-traveled highway recently decided to try an alternative strategy to posting his property, which I like to call "positive posting."

This landowner's decision to spend about \$400 on 20 orange and black aluminum signs, is based upon an understanding of the public's traditional expectations, and a need to educate people about the use of private land and promote a code of user ethics. The message is simple: "Please Respect Owner's Property: Keep Our Land & Waters Clean." It is directed at a variety of Tree Farm users including picnickers, canoeists, anglers, hunters, snowmobilers and, of course, loggers.

It is difficult to gauge the success of this "positive posting" program because increased levels of user respect and ethical behavior are not easy to measure. Suffice it to say that the message has been accepted by the majority of users, with only two signs torn down and seven bullet holes sustained during the two years that the signs have been in place.

It appears that about three-quarters of Maine's timberland owners currently permit some sort of public use (regulated or unregulated) on some 13.5 million acres of private timberland. But with increasing recreational pressure on a shrinking timberland base, the longstanding tradition of public access to private land may change rapidly unless something is done to foster cooperation—rather than confrontation—between landowners and recreationists. The state legislature recognized this problem in its recent approval of LD 1479: An Act to Promote Landowner Relations, which directs the Department of Inland Fisheries & Wildlife (IF&W) to develop appropriate programs to this end.

A second notable effort currently underway is Project LandShare, sponsored by the members of the Maine Forest Products Council. Attractive signs identifying owners of working woodland who provide public access, are showing up on industrial timberlands around the state. With the active support and cooperation of IF&W, the Maine Tree Farm Committee, SWOAM and SMI, Project LandShare might eventually be available to a substantial portion of those 90,000 woodland owners already permitting public recreation.

*David Rock is a professional forester with Forestry Services in Troy, Maine.*



*I incurred last year eligible?*

The tree planting you did last year is called afforestation, not reforestation, since the site was not one on which trees recently existed. Nevertheless, the costs you incurred are eligible for both the amortization and the tax credit, just as if you had reforested following a harvest.

*I have several roads on my forest property that I use for managing and inspecting the land. Since these are permanent roads that have been in existence for a long time, I have been told that any costs I incur for maintaining them are not deductible on my tax return as would be the case if they were only temporary roads. Is this correct?*

Whatever costs you incurred, if any, to construct the roadbeds of these roads are capital costs which are part of the basis of the land. They are not recoverable (deductible) unless you sell the land. Costs incurred to maintain the roads, however, are currently deductible. These would include expenditures for grading and "brushing out." In addition, culverts and bridges associated with permanent roads can be depreciated over 15 years.

*I recently sold some timber that had been blown down by a windstorm. I managed to salvage it soon enough so that I still realized a profit after taking the depletion deduction. I've heard that it may be possible not to pay tax on this profit. What are the rules that apply to this type of situation?*

The tax law (Section 1033 of the Internal Revenue Code) permits a deferral of the tax due on gains such as yours if the proceeds are reinvested in like-kind properties within two years following the year of the casualty. Expenditures that qualify include those made for site preparation and planting; the purchase of standing timber and/or land and timber; road, bridge and culvert repair and/or replacement; and the purchase of sufficient stock in a forest products or timber growing corporation to gain voting control. There is no IRS form on which to indicate that you are electing this option. You should explain your intentions on a plain sheet of paper attached to the tax return for the year the sale proceeds are received. To the extent that replacement property has already been acquired at that time, the details should be given. If all or part of the reinvestment is not made until later, attach the explanation to the tax return for the later year.

*I have been told that Form T, the IRS timber form, is not required to be used by small landowners but only by the big companies. Is this correct?*

Form T is required to be filed by all taxpayers who have had timber transactions or activities mentioned on the form. A penalty can be assessed for not filing it. This seldom occurs, but I know of several instances where it has happened. The IRS timber staff is stressing its use and has alerted other IRS personnel to check for Form T when examining tax returns involving timber transactions.

**William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to *National Woodlands* readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583.**

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